Supreme Court, U.S.
FILED
SEP - 7 2000
CLERK

(4)

No. 00-205

In the

Supreme Court of the United States

Ruth E. Johnson, Commissioner of Revenue,
State of Tennessee,

Petitioner,

v.

J.C. Penney National Bank,

Respondent.

On Petition for a Writ of Certiorari to the Court of Appeals of Tennessee

Brief of the States of New Jersey, Alaska, Colorado, Florida, Idaho, Illinois, Iowa, Maryland, Michigan, Missouri, Montana, North Dakota, Ohio, Oklahoma, Oregon, Pennsylvania, South Carolina, and Utah as Amici Curiae in Support of Petitioner

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QUESTION PRESENTED

May a State, in accordance with the nexus requirements of the Commerce Clause, impose franchise and income-based taxes on corporations that derive significant economic benefits from regular and continuous activities conducted in that State through means of interstate commerce, even though those corporations lack the physical presence in the State that this Court required in *National Bellas Hess, Inc. v. Department of Revenue* and *Quill Corporation v. North Dakota* for imposing a use-tax-collection duty?

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STATEMENT OF AMICI INTEREST

The amici States have substantial interests in determining the extent to which the Commerce Clause permits the imposition of State corporate franchise and income-based taxes on entities that derive significant economic benefits from conducting business in States in which those entities do not have a physical presence. Corporate franchise and income-based taxes are indispensable components of many States' budgets, generating essential revenue to pay the costs of services provided to corporations that conduct business in the States, as well as to maintain the infrastructure necessary for interstate commerce. Forty-six States impose these taxes on corporate entities. CCH Multistate Corporate Income Tax Guide ¶196. The lower court decision seriously restricts a State's ability to collect taxes from businesses that avail themselves of the State's services and reap the benefits of the State's maintenance of a marketplace merely because those entities are not physically present in the State.

The corrosive impact of such a restrictive interpretation of the Commerce Clause on State taxing authority will grow as the explosion in technological advances continues to make it easier for enterprises to conduct business in a particular location without being physically present there. With each passing day, the correlation between where a company's physical assets are located and where that company derives its profits becomes increasingly remote. With those changes, a Commerce Clause standard based on the physical presence of a taxpayer becomes obsolete and unworkable. This Court's Commerce Clause jurisprudence, and the States' ability to collect revenue from corporations that benefit from State services, should evolve along with modern business practices and take into account the growing irrelevance of a corporation's physical presence to its business transactions.

The importance of this issue to the States is highlighted by the number of recently decided and currently pending disputes raising the question of the States' authority to impose corporate franchise and income-based taxes on entities that

conduct business in jurisdictions in which they are not physically present. Tennessee's petition details several recent published opinions grappling with the issue of whether this Court intended for the holding in *Quill* to be freed from its moorings in the sales tax context and applied to all manner of State taxes. The amici States bring to the Court's attention several additional cases involving this issue that are pending in administrative or judicial bodies and which might otherwise escape the Court's notice because they have not yet generated published opinions. In light of the importance of the issue presented in the petition and the extent of the current controversy over the scope of State taxing authority in this area, the amici States join Tennessee in urging the Court to grant certiorari.

REASONS FOR GRANTING THE WRIT

Review of the question presented by the petition is a matter of critical importance to the States because an overly restrictive interpretation of the Commerce Clause will preclude States from collecting properly apportioned franchise and income-based taxes from corporations that purposely avail themselves of economic opportunities in a particular State while studiously avoiding physical presence there. The impact of such a rule on State tax revenue will only magnify as the breakneck pace at which modern business practices are developing continues and business transactions become less and less dependent on physical interaction and location to conduct business. As the need to carry out business through physical contact fades into obscurity, a physical-presence requirement for the imposition of State franchise and income-based taxes, which may once have made sense, will become increasingly archaic and unfair to the States, which will nonetheless be required to continue to provide the services and infrastructure necessary to maintain profitable marketplaces for business endeavors.

The important objectives served by the collection of those levies will be directly hindered if the Commerce Clause is interpreted in too strict a fashion and the States are excluded from collecting tax revenue from the very business enterprises that reap the benefits of State services and protection merely because those businesses lack a physical presence in the taxing jurisdiction. The maintenance of the infrastructure necessary to accommodate interstate commerce, as well as the provision of a judicial system to protect and enforce commercial transactions, are but two of the many valuable services provided by States to business entities, whether or not those entities have physical property in the States in which they exploit the marketplace for profit.

As described more fully below, the scope of Commerce Clause limitations on State corporate taxation is an unsettled question. Many States are actively seeking a judicial determination of the extent to which they may impose franchise and income-based taxes on entities that earn profits in their jurisdictions without being physically present there. State court decisions in this area are in disarray. This Court's intervention is necessary to provide guidance to the States on a topic of vital importance to their economic stability and their ability to provide essential governmental services. The petition for certiorari should be granted.

I. MANY STATES ARE ACTIVELY SEEKING TO RESOLVE THE UNSETTLED QUESTION PRESENTED BY THE PETITION.

The question of whether the bright-line, physical-presence test established in *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992), applies to State taxes outside the use-tax context is under active dispute in several States. In its petition, Tennessee points to numerous published opinions espousing conflicting views on the applicability of the *Quill* physical-presence test to various State taxes. Some courts have faithfully abided by this Court's limitation of the holding

in *Quill* to the use-tax context. *See Couchot v. State Lottery Comm'n*, 659 N.E.2d 1225 (Ohio), *cert. denied*, 519 U.S. 810 (1996) (holding *Quill* physical-presence test not applicable to State income tax on non-residents); *Geoffrey, Inc. v. South Carolina Tax Comm'n*, 437 S.E.2d 13 (S.C.), *cert. denied*, 510 U.S. 992 (1993)(declining to extend *Quill* physical presence test to corporate franchise taxes); *Borden Chemicals & Plastics, LP v. Zehnder*, 726 N.E.2d 73 (Ill. App.)(holding *Quill* physical-presence test does not preclude application of State income tax to members of non-resident partnership), *app. denied*, 731 N.E.2d 762 (Ill. 2000).

Other courts, including the court below, have extended *Quill*'s limitation on State taxing authority to other forms of taxation. *See Guardian Indus. Corp. v. Department of Treasury*, 499 N.W.2d 349, 356 (Mich. App. 1993)(holding that "after Quill, it is abundantly clear that [a State] must show a physical presence . . . to establish substantial nexus to tax it."), *app. denied*, 512 N.W.2d 846 (Mich. 1994); *MCI Int'l Telecommunications Corp. v. Comptroller of the Treasury*, 1999 WESTLAW 322702 (Md. Tax Ct. 1999), *aff'd*, 2000 STT["State Tax Today"] 60-22 (Md. Cir. Ct. March 17, 2000)(applying physical presence type test to corporate income tax); *Cerro Copper Products, Inc. v. Alabama Dept. of Revenue*, No. F94-444 (Ala. Adm. Judge, Dec. 11, 1995), State Tax Notes, Jan. 1, 1996, at 65, 66 (holding that taxpayer which lacks sufficient nexus with State for sales and use tax purposes also lacks sufficient nexus for corporate franchise tax purposes).

Tennessee's petition actually understates the extent to which the issue is presently in dispute in the State courts. Numerous other challenges to the imposition of State taxes based on the taxpayer's purported lack of physical presence are pending in State administrative and judicial tribunals.

New Jersey is defending imposition of its Corporation Business Tax, *N.J. Stat. Ann.* §54:10A-1, *et seq.* (West

2000), to a corporation that profits from the use of its intangible property -- trademarks, service marks, and tradenames -- in that State but has no physical presence there. *Lanco, Inc. v. Director, Div. of Taxation*, N.J. Tax Court, Docket No. 005329-1997. A similar action is pending in Iowa, where that State seeks to impose its corporate income tax on an entity that receives royalties from the use of its trademarks and tradenames in Iowa but is not physically present in the State. *In re: Pepisco, Inc. & Affiliates*, Iowa Department of Revenue and Finance, Docket No. 99-24-1-0130. The same issue is presently in dispute in New Mexico, where that State seeks to collect its corporate franchise and income taxes on a corporation that receives royalties for the use of its intangible property -- the trademarks and tradenames associated with K-Mart Stores -- in New Mexico but has no physical presence there. *In re: Kmart Properties, Inc.*, New Mexico Taxation and Revenue Department, Docket No. 00-04. The Massachusetts Appellate Tax Board recently permitted the taxation of a trademark holding company with no physical presence in the Commonwealth only after finding that the company's creation was a sham carried out by a separate entity that was physically present there. *Sherwin-Williams Co. v. Commissioner of Revenue*, Docket No. F233560.

The existence of so many active disputes concerning the applicability of the *Quill* physical-presence test to various State taxes highlights the need for this Court's review of the decision below. The significance of obtaining certainty in this area of unquestioned importance to the provision of vital State services has prompted a large number of States to seek judicial guidance on the scope of their corporate taxing authority in light of the holding in *Quill*. The published opinions generated to date demonstrate the division among the lower courts on this important question. The number of pending actions raising the issue underscores the exceptional significance attributed to this question by the States. A decision by this Court on Tennessee's appeal would bring

much-needed clarity and resolution to an area of overriding State concern.

II. THE PHYSICAL-PRESENCE TEST ARTICULATED IN *QUILL* IS INCOMPATIBLE WITH MODERN BUSINESS PRACTICES AND ITS APPLICATION TO THE AREA OF STATE CORPORATE FRANCHISE AND INCOME-BASED TAXES IS UNWARRANTED.

The confusion that reigns among State courts is not surprising. Eight years ago, Justice White predicted that there would be a deluge of litigation concerning the meaning of the substantial nexus test articulated in *Quill*. 504 U.S. at 331 (White, J., concurring in part and dissenting in part). The storm has arrived. The Tennessee Court of Appeals is just the most recent State court that finds itself seeking a principled and reasonable analysis of the Commerce Clause in the modern business environment. Unfortunately, the lower court is also only the most recent tribunal to stray from the true tenets of the Commerce Clause by focusing inappropriately on the physical presence of the business in the taxing State rather than on the impact on interstate commerce resulting from application of a particular tax. It is time to clarify the permissible scope of State taxation under the Commerce Clause.

The Commerce Clause grants to Congress the power to regulate interstate commerce, thereby implicitly prohibiting States from taking action that impedes interstate commerce. *U.S. Const.* Art. I, § 8, cl. 3; *Quill*, *supra*, 504 U.S. at 309. Specifically, States are barred from discriminating against interstate commerce or unduly burdening interstate economic activity. *Id.* at 312. However, businesses engaging in interstate commerce may be required to bear their fair share of the cost of the State governments, whose protection and services they enjoy. *National Bellas Hess, Inc. v. Department of Revenue*, 386 U.S. 753, 756 (1967). Hence, the central inquiry of a Commerce Clause challenge to the application of

a State tax statute should not be whether the business has a presence in the taxing State but, rather, whether application of the tax unduly interferes with interstate commerce. *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 285 (1977).

In *Complete Auto*, this Court described a State tax that does not produce forbidden results: "net income from the interstate operations of a foreign corporation may be subjected to state taxation, provided the levy is not discriminatory and is properly apportioned to local activities within the taxing State forming sufficient nexus to support the tax." *Id.* at 285. The Court broke this rule down into four parts: a State tax does not contravene the Commerce Clause if it "[1] is applied to an activity with a substantial nexus with the taxing State, [2] is fairly apportioned, [3] does not discriminate against interstate commerce, and [4] is fairly related to the services provided by the State." *Id.* at 279. The four prongs are designed to flesh out the relationship between the taxing State and the activities conducted there by the business; the potential for multiple taxation on the same activity; the difference, if any, between the tax imposed on intrastate activities or in-state businesses and that imposed on interstate activities or out-of-state businesses; and the State services the business may avail itself of in the course of its business activities.

This test was applied in the context of use tax on an out-of-State mail order house in *Quill*. There, the Court explained that prongs one and four of the *Complete Auto* test, that there be a substantial nexus between the activity and the taxing State, and that there be a relationship between the tax and the services provided by the State, "limit the reach of state taxing authority so as to ensure that state taxation does not unduly burden interstate commerce." *Quill*, *supra*, 504 U.S. at 313 (footnote omitted). Prongs two and three "prohibit taxes that pass an unfair share of the tax burden onto interstate commerce." *Id.* at 313.

The first-prong "substantial nexus" requirement is "informed . . . by structural concerns about the effects of state regulation on the national economy." *Id.* at 312. However, subsequent case law, including the decision below, demonstrates that the first prong of the *Complete Auto* test is too frequently addressed in isolation, de-coupled from concerns about the potential effects of the State tax on the national economy. This approach threatens to stretch the *Complete Auto* test beyond its intended purposes to permit State tax laws to be struck down purely on the basis of a factual inquiry into whether the corporate taxpayer is physically present in a State, rather than based on a reasoned analysis of whether application of a particular State tax has a detrimental effect on interstate economic activity.

Moreover, the *Quill* decision appears to be less an analysis of modern business practices than a reflection of the importance of *stare decisis* in the context of State use taxes, an area in which a physical-presence test was established twenty-five years earlier in *National Bellas Hess*. While this Court in *Quill* was loyal to the *stare decisis* effect of the *National Bellas Hess* physical-presence test, the rule's limited analytical usefulness was acknowledged. This Court explained that the bright-line test is "artificial" but excusable because vendors had relied on the fact that under *National Bellas Hess* a State may not impose a use-tax collection requirement on a corporation unless it had a physical presence in the State. *Id.* at 315. However, given the rapid evolution of commercial activity, the Commerce Clause is no longer amenable to bright-line tests and is better addressed by a balancing of interests presented when a State franchise or income-based tax is imposed on a corporation which lacks physical presence in the taxing State.

If the Commerce Clause is to be realistically applied in today's business climate, courts must "look[] past 'the formal language of the tax statute [to] its practical effect'" and determine whether its application actually burdens interstate

commerce or discriminates against economic activity. *Id.* at 310 (quoting *Complete Auto*, *supra*, 430 U.S. at 279). The bright line drawn in *Quill* in the use-tax collection context is anachronistic and ignores the modern reality of interstate businesses. The use of this test for State corporate franchise and income-based taxation will stunt the evolution of Commerce Clause jurisprudence, as courts will be precluded from engaging in the type of balancing of interests more appropriate for today's changing economic environment.

Physical presence in a State does not necessarily signify a significant degree of business activity there. By the same token, with modern advances in communications and transportation, an entity's physical presence in a State is not at all determinative of the corporation's ability to receive substantial economic benefits from the State's marketplace. Simply put, in today's world of high speed, remote communications, physical presence becomes increasingly irrelevant with each passing day.

This Court has already recognized the insignificance of a business' physical presence in a taxing State for Due Process Clause purposes. This Court "abandoned more formalistic tests that focused on a defendant's 'presence' within a State in favor of a more flexible inquiry . . . ." *Id.* at 307. "In 'modern commercial life' it matters little that such solicitation is accomplished by a deluge of catalogs rather than a phalanx of drummers: The requirements of due process are met irrespective of a corporation's lack of physical presence in the taxing State." *Id.* at 308.

The rationale for abandoning a physical-presence requirement for Due Process Clause purposes recognizes that businesses engage in significant levels of commercial activity in a State without ever "setting foot" there. Enterprises readily foresee being subject to State laws, including tax laws, as a result of their commercial activity directed at a particular State. *See Burger King Corp. v. Rudzewicz*, 471 U.S. 462,

476 (1985). There is no principled reason why the Commerce Clause should require a corporation's physical presence to justify State taxation, provided the State can establish that the corporation derives significant benefits from continued and deliberate economic activity in the taxing State. Surely, business entities benefit from a well-maintained transportation and communication infrastructure that allows the wheels of interstate commerce to turn and from the protection accorded commercial transactions by a State's judicial system.

A sharper focus should be placed on the Commerce Clause inquiry: whether the activities of the business have a sufficient connection with the taxing State and whether the level of economic activity is such that the entity reasonably should expect to draw on State protection and services and, in turn, to pay for that protection and services. The remaining elements of the *Complete Auto* test -- that the tax is fairly apportioned, non-discriminatory against interstate commerce, and fairly related to the services provided by the taxing State -- ensure that companies that engage in intrastate activity will not be favored over interstate economic actors, fully effectuating the purposes of the Commerce Clause.

The potential burden on interstate commerce that appeared to worry this Court in *Quill* was the threat of imposition of use-tax collection obligations on out-of-State businesses by the large number of jurisdictions that impose the tax. As this Court noted, in 1992, at least 6,000 jurisdictions imposed use tax, and many required collection of the tax multiple times a year. *Quill*, *supra*, 504 U.S. at 313, n. 6. The administrative cost to an out-of-state seller of complying with thousands of distinct taxing jurisdictions might be significant, although with the availability of modern computer technology even that assumption is suspect. Corporate franchise and income-based taxes, on the other hand, are imposed by only 46 States and 2 jurisdictions and are likely to be collected annually. CCH Multistate Corporate Income Tax Guide ¶196. Moreover, these taxes are

apportioned to receipts from business conducted in the taxing State and many of the taxes are based on the annual income already reported by the corporations for federal tax purposes. Approximately forty-four States use this measure. CCH Multistate Corporate Income Tax Guide ¶125. The realities of State corporate franchise and income-based taxes simply do not threaten to impose a meaningful administrative burden on interstate economic actors.

It is time to reevaluate the Commerce Clause in the State corporate franchise and income-based tax context, and provide States with appropriate guidance in this important area. Technology has progressed in quantum leaps and bounds in the eight years since *Quill* and the twenty-three years since *Complete Auto* were decided. The States have a demonstrated need for a decision from this Court outlining the parameters of their taxing authority in the increasingly common circumstance in which a corporation earns significant profits in a State without being physically present there.

CONCLUSION

For the foregoing reasons, the petition for a writ of certiorari should be granted.

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Dated:
September 5, 2000